

No. 10037.

IN THE

United States Circuit Court of Appeals  
FOR THE NINTH CIRCUIT

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PACIFIC SOUTHWEST REALTY COMPANY, a corporation,  
*Petitioner,*

*vs.*

COMMISSIONER OF INTERNAL REVENUE,  
*Respondent.*

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PETITIONER'S OPENING BRIEF.

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Jurisdictional Statement.

This is an appeal from a decision of the United States Board of Tax Appeals in which deficiencies in income taxes were determined against petitioner for the years 1936 and 1937. The opinion below [R. 37] is reported at 45 B. T. A. 426.

Petitioner is a Delaware corporation and has its principal office in Los Angeles, California. Petitioner's income tax returns for the years 1936 and 1937 were filed with the Collector of Internal Revenue for the Sixth District of California. [R. 4, 36, 137.] Respondent determined deficiencies in petitioner's income taxes for the years 1936 and 1937 in the amounts of \$842.75 and \$13,878.81,

respectively, and on February 21, 1940, pursuant to Section 272 of the Internal Revenue Code, respondent sent to petitioner a notice of said deficiencies. [R. 4, 16.] On March 6, 1940, petitioner filed with the Collector of Internal Revenue for the Sixth District of California its written claim for refund of income taxes overpaid by it for the year 1936 in the amount of \$53,900.53. [R. 13, 22, 144.] On May 13, 1940, pursuant to Section 272 of the Internal Revenue Code, petitioner filed its appeal from the aforesaid proposed deficiencies and prayed for a determination that there was no deficiency for either year and for a further determination that petitioner overpaid its income taxes for the year 1936 in the amount of \$53,900.53. [R. 3.] After the hearing, at which a stipulation of facts and oral and documentary evidence were submitted, the Board of Tax Appeals entered its decision in favor of respondent on October 27, 1941. [R. 65.] On December 26, 1941, under authority of Section 1141 of the Internal Revenue Code (28 U. S. C., Section 1141) petitioner filed its Petition for Review by this Court of said decision of the Board of Tax Appeals. [R. 66.] This appeal and the transcript of record herein were filed and docketed in this Court on February 2, 1942. [R. 208.]



## Statement of the Case.

The facts in this appeal are not in dispute and they present three principal legal issues, which may be stated as follows:

### ISSUES.

I. Whether petitioner was indebted to the holders of its securities designated  $6\frac{1}{2}\%$  Cumulative Preferred Serial Stock and  $5\frac{1}{2}\%$  Cumulative Preferred Serial Stock and whether the so-called dividends paid to the holders thereof were in fact interest payments on indebtedness.

II. Whether petitioner was entitled to deductions for 1936 and 1937 for a portion of the discount at which its securities designated  $5\frac{1}{2}\%$  Cumulative Preferred Serial Stock were issued and sold.

III. Whether petitioner was entitled to deductions in 1936 and 1937 for the amounts paid as premiums upon the retirement of its securities designated  $6\frac{1}{2}\%$  Cumulative Preferred Serial Stock and  $5\frac{1}{2}\%$  Cumulative Preferred Serial Stock.

The pertinent facts may be summarized as follows:

### ISSUE I.

1. Petitioner is a corporation organized under the laws of the State of Delaware and has its principal place of business in the City of Los Angeles, California. [R. 137.]

2. Petitioner was incorporated by persons affiliated with the Pacific Southwest Trust and Savings Bank and First National Bank of Los Angeles for the purpose of acquiring and thereafter owning and operating all the real

estate properties owned by the Pacific Southwest Trust and Savings Bank and one parcel of real estate owned by the First National Bank of Los Angeles, and for the further purpose of providing additional bank premises as the growth of the banks required. [R. 137.] The reason for the organization of petitioner was that the growth of the banks required additional investment in bank premises and in order not to lock up the funds of the bank in real estate used for bank premises it was deemed advisable to organize a subsidiary company to own the real estate and to employ outside capital for that purpose. [R. 137, 159.]

3. All of the common stock of petitioner was issued to First Securities Company, an affiliate of the above banks. [R. 138.]

4. During the years 1923, 1924 and 1925 petitioner issued and sold its securities designated  $6\frac{1}{2}\%$  Cumulative Preferred Serial Stock. [R. 138.] During the year 1928 petitioner issued and sold its securities designated  $5\frac{1}{2}\%$  Cumulative Preferred Serial Stock. [R. 140.] Said securities were issued in accordance with and pursuant to the authority granted by article fourth of petitioner's certificate of incorporation. [R. 138, 140.] A true copy of article fourth of the certificate of incorporation is attached to the stipulation of facts as Exhibit "A" [R. 146] and a true copy of said article fourth of the certificate of incorporation as amended in 1927 is attached to the stipulation of facts as Exhibit "G." [R. 179.] Each of said securities was issued in series. The first series (series A) of the  $6\frac{1}{2}\%$  Cumulative Preferred Serial Stock matured and became payable on July 1, 1929, and the remaining series were to mature and become payable successively on the first day of July of each year there-

after to and including the year 1951. [R. 138.] The first series of the 5½% Cumulative Preferred Serial Stock (series AA) was to mature and become payable on July 1, 1939, and the remaining series were to mature and become payable successively on July first of each year thereafter to and including the year 1960. [R. 140.] The maturity dates of each series of said securities were set forth in the certificate of incorporation and the maturity date of each security was stated on the face of the certificate issued. [R. 157, 191.]

5. Said securities provided for the payment to the holders thereof of so-called dividends in the amount of 6½% per annum and 5½% per annum, respectively. The so-called dividends to be paid to the holders of said securities were limited to the specified percentages. It was provided in the certificate of incorporation and on the face of the certificates issued that upon the maturity date specified each series of said securities "shall be redeemed at par plus unpaid, accrued and accumulated dividends thereon." [R. 153, 187.] It was further provided: "In the event that the corporation shall fail to redeem" any series at the time and place specified "the holders thereof shall have the right to enforce payment of the par value of said stock so agreed to be redeemed, together with the amount of any unpaid, accrued or accumulated dividends thereon, the same as any unconditional claim or debt against the corporation." [R. 153, 187.] It was further provided: "In the event of any liquidation, dissolution or winding up of the corporation, whether voluntary or involuntary," the holders of said securities "shall be entitled, before any distribution shall be made to the holders of the common stock, to be paid out of the surplus profits arising from the business of this corpora-

tion, and then remaining intact, or in case such profits shall be insufficient, then from the general assets of this corporation, an amount equal to the par value thereof plus said fixed redemption premium, plus all unpaid, accrued, or accumulated dividends thereon." [R. 151, 185.]

6. At the time said securities were issued petitioner had a lease agreement with Pacific Southwest Trust and Savings Bank whereby said bank was obligated to pay as rental a sum which, with the other income of petitioner, would be sufficient to pay all of petitioner's operating expenses and the so-called dividends on petitioner's cumulative preferred serial stock, and interest on petitioner's mortgage bonds and the sums necessary to redeem said securities and bonds at maturity. [R. 140, 176.]

7. The holders of said securities had no voting rights or rights to participate in the management of the corporation except in case of default in payment of the so-called dividends and the continuance of such default for a period of ninety days, in which event the holders of said securities had exclusive voting rights until said default was cured. [R. 154, 188.]

8. Petitioner's said securities were dealt in, in "over-the-counter" transactions and accrued dividends, prior to actual declaration thereof, were generally taken into consideration in substantially the same manner and to the same extent as accrued interest upon bonds is taken into consideration upon purchase or sale. [R. 39.]

9. During the year 1936 petitioner made payments of so-called dividends to the holders of its 6½% Cumulative Preferred Serial Stock and 5½% Cumulative Preferred Serial Stock in the amounts of \$65,300.63 and \$55,000.00, respectively. [R. 140, 141.] During the year 1937 peti-

tioner made payments of so-called dividends to the holders of its 5½% Cumulative Preferred Serial Stock in the amount of \$41,250.00. [R. 141.]

10. In its income tax return for the year 1937 petitioner took deductions for the aforesaid payments made on its said securities as interest paid on indebtedness. [R. 144.] In its income tax return for the year 1936 petitioner did not take deductions for said payments, but claimed the right to said deductions in a claim for refund later filed with the Commissioner of Internal Revenue. [R. 22.] Respondent denied petitioner's right to said deductions on the ground that petitioner's said securities were preferred stock. [R. 21.]

## ISSUE II.

### *Additional Facts Pertaining to Issue II.*

11. Petitioner's securities designated 5½% Cumulative Preferred Serial Stock were issued and sold at discounts. It is stipulated that

"If the discount at which said securities were sold was a deductible expense it was an expense which it was proper to amortize and deduct over the life of said securities and \$1,833.26 of said discount expense was properly allocable to the year 1936 and \$31,275.39 of said discount expense was properly allocable to the year 1937." [R. 141.]

12. In its income tax return for the year 1937 petitioner took a deduction for \$31,275.39 of said discount expense. [R. 144.] In its income tax return for the year 1936 petitioner did not take a deduction for any portion of said discount expense, but claimed the right to a deduc-

tion therefor in the amount of \$1,833.26 in a claim for refund duly filed. [R. 22.] Respondent refused to allow said deduction on the ground that petitioner's securities were preferred stocks. [R. 21.]

### ISSUE III.

#### *Additional Facts Pertaining to Issue III.*

13. During the year 1936 petitioner redeemed and retired all of its then outstanding securities designated 6½% Cumulative Preferred Serial Stock for the face value thereof plus a total premium of \$182,025.00. [R. 142.]

14. During the year 1937 petitioner redeemed and retired all of its then outstanding securities designated 5½% Cumulative Preferred Serial Stock for the face value thereof plus a total premium of \$20,000.00. [R. 142.]

15. In its income tax return for the year 1937 petitioner took a deduction for the \$20,000.00 premium paid during the year 1937. [R. 144.] In its income tax return for the year 1936 petitioner did not take a deduction for the premium paid during said year, but claimed the right to the deduction of said premium in the amount of \$182,025.00 in a claim for refund duly filed. [R. 22.] Respondent refused to allow said deductions on the ground that petitioner's securities were preferred stocks. [R. 21.]

#### *Facts in Regard to Payment of Tax and Claim for Refund.*

16. Petitioner filed its income tax return for the year 1936 on March 15, 1937, and paid the tax shown thereon in the amount of \$83,251.08 in installments as follows:



\$20,812.77 on March 15, 1937, and like amounts on June 12th, September 13th and December 13, 1937. [R. 143.] On March 6, 1940, petitioner duly filed its claim for refund of income taxes overpaid by it for the year 1936 in the amount of \$53,900.53. [R. 144.] On May 22, 1940, petitioner paid to the Collector of Internal Revenue for the Sixth District of California the deficiencies in income taxes proposed for the years 1936 and 1937 and herein contested. Said payments were as follows: \$842.75 tax, \$161.09 interest, or a total payment of \$1,003.84 for the year 1936, and \$13,878.81 tax, \$1,820.21 interest, or a total payment of \$15,699.02 for the year 1937. [R. 145.]

*Decision of Board of Tax Appeals.*

17. The Board of Tax Appeals determined that petitioner's securities designated 6½% Cumulative Preferred Serial Stock and 5½% Cumulative Preferred Serial Stock were preferred stocks and held that respondent committed no error in denying the claimed deductions for interest, discount and premiums. [R. 59-60.] The Board further held that petitioner was not entitled to a deduction for certain taxes paid in 1936. [R. 64.] The conclusion of the Board with regard to the deduction of said taxes was assigned as error, but will not be urged in this appeal. The Board made and entered its decision in favor of respondent [R. 65] and petitioner brings this appeal from said decision. [R. 66.]

### Summary of Argument.

I. Petitioner contends that since, under the terms and conditions of its securities designated  $6\frac{1}{2}\%$  Cumulative Preferred Serial Stock and  $5\frac{1}{2}\%$  Cumulative Preferred Serial Stock petitioner was required to repay the face value of said securities and to pay the so-called dividends at the rate fixed on or before the maturity dates which were stated on the face of the security certificates, and since petitioner's said obligation was enforceable against petitioner the same as any unconditional claim or debt, petitioner was indebted to the holders of securities and the so-called dividends were in fact interest on indebtedness and were deductible under Section 23(b) of the Revenue Act of 1936.

II and III. That since said securities represented indebtedness of petitioner to the holders thereof, the discount at which they were sold and the premium at which they were redeemed were deductible expenses.

### Specification of Errors.

The errors relied upon by petitioner (separately stated below) all result from the erroneous determination of the Board of Tax Appeals that petitioner was not indebted to the holders of its securities designated  $6\frac{1}{2}\%$  Cumulative Preferred Serial Stock and  $5\frac{1}{2}\%$  Cumulative Preferred Serial Stock and that therefore:

- (a) The so-called dividends paid during the years 1936 and 1937 were not interest paid on indebtedness;



- (b) The discount at which the  $5\frac{1}{2}\%$  Cumulative Preferred Serial Stock sold was not deductible;
- (c) The premiums paid upon redemption of said securities were not deductible.

The United States Board of Tax Appeals erred—

1. In determining a deficiency in petitioner's income tax for the year 1936 in the amount of \$842.75.
2. In failing to determine that petitioner overpaid its income taxes for the year 1936 in the amount of \$53,900.53.
3. In determining a deficiency in petitioner's income tax for the year 1937 in the amount of \$13,878.81.
4. In determining that the securities issued by petitioner and designated as  $6\frac{1}{2}\%$  Cumulative Preferred Serial Stock were preferred stock.
5. In failing and refusing to determine that the securities issued by petitioner and designated as  $6\frac{1}{2}\%$  Cumulative Preferred Serial Stock evidenced indebtedness of the petitioner to the holders of said securities.
6. In determining that the securities issued by petitioner and designated as  $5\frac{1}{2}\%$  Cumulative Preferred Serial Stock were preferred stock.
7. In failing and refusing to determine that the securities issued by petitioner and designated as  $5\frac{1}{2}\%$  Cumulative Preferred Serial Stock evidenced indebtedness of the petitioner to the holders of said securities.
8. In failing and refusing to determine that the sum of \$65,300.63 paid by the petitioner during the year 1936

to the holders of its securities designated 6½% Cumulative Preferred Serial Stock was interest paid on indebtedness within the meaning of Section 23(b) of the Revenue Act of 1936.

9. In determining that the sum of \$65,300.63 paid by petitioner during the year 1936 to the holders of its securities designated 6½% Cumulative Preferred Serial Stock was not deductible as interest paid on indebtedness.

10. In failing and refusing to determine that the sum of \$55,000.00 paid by the petitioner during the year 1936 to the holders of its securities designated 5½% Cumulative Preferred Serial Stock was interest paid on indebtedness within the meaning of Section 23(b) of the Revenue Act of 1936.

11. In determining that the sum of \$55,000.00 paid by petitioner during the year 1936 to the holders of its securities designated 5½% Cumulative Preferred Serial Stock was not deductible as interest paid on indebtedness.

12. In failing and refusing to determine that the sum of \$41,250.00 paid by the petitioner during the year 1937 to the holders of its securities designated 5½% Cumulative Preferred Serial Stock was interest paid on indebtedness within the meaning of Section 23(b) of the Revenue Act of 1936.

13. In determining that the sum of \$41,250.00 paid by petitioner during the year 1937 to the holders of its securities designated 5½% Cumulative Preferred Serial Stock was not deductible as interest paid on indebtedness.

14. In failing and refusing to determine that petitioner was entitled to a deduction for the year 1936 for the portion of the discount at which its securities designated  $5\frac{1}{2}\%$  Cumulative Preferred Serial Stock were sold which was allocable to 1936.

15. In failing and refusing to determine that petitioner was entitled to a deduction for the year 1937 for the portion of the discount at which its securities designated  $5\frac{1}{2}\%$  Cumulative Preferred Serial Stock were sold which was allocable to 1937.

16. In failing and refusing to determine that petitioner was entitled to a deduction for the year 1936 in the amount of \$182,025.00 for the premium paid by petitioner during the year 1936 on the redemption of its securities designated  $6\frac{1}{2}\%$  Cumulative Preferred Serial Stock.

17. In failing and refusing to determine that petitioner was entitled to a deduction for the year 1937 in the amount of \$20,000.00 for the premium paid by petitioner during the year 1937 on the redemption of its securities designated  $5\frac{1}{2}\%$  Cumulative Preferred Serial Stock.

est regardless of the name of the security and regardless of the name used to describe the payments.

*Commissioner v. Palmer, Stacy-Merrill, Inc.* (C. C. A. 9, 1940), 111 Fed. (2d) 809;

*Commissioner v. Proctor Shop, Inc.* (C. C. A. 9, 1936), 82 Fed. (2d) 792;

*Commissioner v. O. P. P. Holding Co.* (C. C. A. 2, 1935), 76 Fed. (2d) 11;

*Helvering v. Richmond F. & P. R. Co.*, *supra*;

*Bolinger-Franklin Lumber Co. v. Commissioner*, *supra*;

*Diamond Calk Horse Shoe Co. v. United States* (D. C. Minn., July 19, 1940. Opinion reported 1940 Prentice-Hall Federal Tax Service, para. 62919, and 1940 C. C. H. Federal Tax Service, para. 9641) (Appeal dismissed—C. C. A. 8, 116 Fed. (2d) 284);

*Commissioner v. J. N. Bray Co.*, *supra*.

3. If under the terms and conditions of the security or other contract between the parties the corporation has no enforceable obligation to repay the principal sum or to pay the specified return on or before a definite date, the security is not a debt and the payments are not interest.

*Elko Lamoille Power Co. v. Commissioner* (C. C. A. 9, 1931), 50 Fed. (2d) 595;

*United States v. South Georgia Railway Co.* (C. C. A. 5, 1939), 107 Fed. (2d) 3;

*Commissioner v. Schmoll Fils Association, Inc.* (C. C. A. 2, 1940), 110 Fed. (2d) 611;

*Brown-Rogers-Dixon Co. v. Commissioner* (C. C. A. 4, 1941), 122 Fed. (2d) 347.

The above principles have been accepted by respondent and incorporated in the Regulations which interpret the excess profits tax law. Regulations 109, Section 30.719-1 sets forth the following principles for determining what constitutes "borrowed capital":

"Whether outstanding certificates designated by such names as 'debenture preferred stock' or 'guaranteed preferred stock' constitute borrowed capital depends upon whether the holder has a proprietary interest in the corporation or has the rights of a creditor, determined in the light of all the facts. The name borne by the certificate is of little importance. More important attributes to be considered are whether or not there is a maturity date, the source of payment of any 'interest' or 'dividend' specified in the certificate (whether only out of earnings or out of capital and earnings), rights to enforce payment, and other rights as compared with those of general creditors."

C. THE TERMS AND CONDITIONS OF PETITIONER'S SECURITIES ESTABLISH THAT PETITIONER WAS INDEBTED TO THE HOLDERS THEREOF.

1. *Petitioner Incurred an Enforceable Obligation to Repay the Principal and Accumulated Dividends on or Before the Maturity Date Specified.*

The securities of petitioner here in question were authorized by Article Fourth of petitioner's Certificate of Incorporation [R. 146-155, 179-190] which specifically provided the terms of the securities, the conditions under which they could be issued and the duties of petitioner to the holders of said securities. The terms and conditions were also printed on the certificates. [R. 157, 191-192.] As the two securities here in question were identical in

all respects material hereto, they will be considered together in this brief.

As indicated by the name, the securities were issued in series with the number of shares in each series and the maturity date of each series stated on the face of the certificate. It was specifically provided that each series "shall be redeemed" on the maturity date specified at par, plus unpaid, accrued and accumulated dividends. [R. 153.] It was further provided "In the event that the corporation shall fail to redeem" any series at the time and place specified "the holders thereof shall have the right to enforce payment of the par value of said stock so agreed to be redeemed, together with the amount of any unpaid, accrued, or accumulated dividends thereon, the same as on any unconditional claim or debt against the corporation". [R. 153.]

In the event of liquidation or dissolution of petitioner, whether voluntary or involuntary, the holders of the 6½% Cumulative Preferred Serial Stock and the 5½% Cumulative Preferred Serial Stock were to receive the par value of the securities, plus the premium and accumulated dividends out of surplus profits, or if the "profits shall be insufficient, then from the general assets of this corporation". [R. 151.]

The rate of the payments to the holders of said securities was likewise definitely fixed at 6½% and 5½% respectively of the par value of the certificates and they were not entitled to receive any greater sums regardless of the profits of the corporation. [R. 150.]

It is clear from the above terms and conditions, which were set forth in the Certificate of Incorporation of petitioner and on the security certificates, that petitioner was definitely obligated to repay to the holders of the securities



in question the principal sum or face value thereof, plus the specified premium and the specified annual return or so-called dividend. The obligation was enforceable by the holders of the securities against petitioner, the same as any unconditional claim or debt, and could be collected from the general assets of petitioner. While the so-called dividends were to be paid currently from the profits of petitioner, all payments which were not made prior to the maturity date of the security accumulated and upon the maturity of the security all such accumulated and unpaid sums were enforceable against the corporation, the same as any unconditional claim or debt against the corporation, and could be collected from the general assets of the corporation. Under the terms and conditions of the security the sums paid therefor were clearly loaned to petitioner for the definite period of time stated on the face of the certificate at the fixed rate of return also stated on the face of the certificate and at the termination of the term specified the repayment of the principal sums, plus any portion of the fixed return not theretofore paid, was enforceable against the general assets of the corporation. Such conditions definitely make the obligation represented by petitioner's said securities indebtedness and the payments thereon interest within the meaning of Section 23(b) of the Revenue Act of 1936.

The only thing in petitioner's Certificate of Incorporation or in the certificates which were issued to represent said securities which is inconsistent with indebtedness is the names and language used. The securities were called stock and the payments to be made to the holders were called dividends. But the use of such terms and names certainly did not relieve petitioner from the obligations specifically and definitely imposed upon it to repay the

principal sums and to pay the annual amounts specified at the times and in the amounts set forth in its Certificate of Incorporation and on the face of the security certificates. Petitioner's obligations and liabilities were much too clearly and definitely stated to have been nullified or avoided by the mere use of names which are ordinarily given to securities which do not carry such obligations and liabilities.

Furthermore, this Court and others have consistently and without exception held that the name given to the security and to the payments on the security are not determinative of the character of the obligation. The courts have consistently gone behind the names used and determined the true character of a security from its basic terms and conditions.

In *Commissioner v. Proctor Shop, Inc.* (C. C. A. 9, 1936), 82 Fed. (2d) 792, and *Commissioner v. Palmer, Stacy-Merrill, Inc.* (C. C. A. 9, 1940), 111 Fed. (2d) 809, this Court held that securities designated "debenture preference stock" and "preferred stock" represented indebtedness and not a stock as the names indicated, and that the payments made to the holders thereof were interest. In each of the above cases the determining factor was that, as in the case at bar, the corporation was definitely obligated to repay the principal sum and the specified dividends on or before a fixed date regardless of earnings. In *Commissioner v. Proctor Shop, Inc.*, *supra*, this Court distinguished its prior decision in *Elko Lamoille Power Co. v. Commissioner*, 50 Fed. (2d) 595, on the ground that in that case, "There was \* \* \* no obligation to redeem".



In *United States v. South Georgia Railway Co.* (C. C. A. 5, 1939), 107 Fed. (2d) 3, in holding the security under consideration to be a stock, the Court stated:

“There is, thus, an entire absence here of the most significant, if not the essential feature of a debtor and creditor as opposed to a stockholder relationship, the existence of a fixed maturity for the principal sum with the right to force payment of the sum as a debt in the event of default.”

The United States District Court, Minnesota, in *Diamond Calk Horse Shoe Company v. United States* (July 19, 1940), (Reported in 1940 Prentice-Hall Federal Tax Service, paragraph 62,919, and 1940 C. C. H. Federal Tax Service, paragraph 9641, Appeal dismissed C. C. A. 8, 116 Fed. (2d) 284) reached the same conclusion in regard to a security designated “preferred stock”. The Court stated:

“The certificate, although designated as preferred stock, has every characteristic of an indebtedness. The corporation, the obligor, is unconditionally bound to pay, regardless of earnings or surplus, to the obligee, the holder of the certificate, a definitely ascertainable sum, to wit, the amount of the investment plus seven per cent at the maturity fixed, which is on or before five years from the date of the issuance of the certificate. Regardless of any name given to the certificate or to the holder thereof, if we disregard the form and consider the substance, we have a debtor-creditor obligation and relationship, and not that of a corporation and stockholder.”

The same test was applied in a similar case by the Circuit Court of Appeals for the Second Circuit in *Commissioner v. O. P. P. Holding Co.* (1935), 76 Fed. (2d)

11. See also *Arthur R. Jones Syndicate v. Commissioner* (C. C. A. 7, 1927), 23 Fed. (2d) 833; *Helvering v. Richmond F. & P. R. Co.* (C. C. A. 4, 1937), 90 Fed. (2d) 971; *Commissioner v. J. N. Bray Co.* (C. C. A. 5, Mar. 13, 1942), ..... Fed. (2d) .....

Where the liabilities and obligations necessary to establish indebtedness were not present, the courts have held payments called "interest" to be in fact not interest but dividends.

*Commissioner v. Schmoll Fils Association, Inc.*  
(C. C. A. 2, 1940), 110 Fed. (2d) 611;

*Brown-Rogers-Dixon Co. v. Commissioner* (C. C. A. 4, 1941), 122 Fed. (2d) 347;

*Ticker Pub. Co. v. Commissioner*, 46 B. T. A. ....  
No. 50.

The rule of the above cases has been accepted and uniformly applied by the courts in the determination of cases of this type. See *Jewel Tea Co. v. United States* (C. C. A. 2, 1937), 90 Fed. (2d) 451; *United States v. South Georgia Railway Co.* (C. C. A. 5, 1939), 107 Fed. (2d) 3.

Petitioner submits that under the rule of the above cases the definite obligation of petitioner to repay the principal sum of its securities and to pay the return specified on or before the maturity date, which obligation was enforceable against the general assets of petitioner, establishes that petitioner's obligation to the holders of said securities was a debt and that the payments made to the holders thereof were interest paid on indebtedness.

2. *The Secondary Terms and Conditions of Petitioner's Securities Are Consistent With and Indicate Indebtedness.*

The other terms and conditions of petitioner's securities were such as might be found either in a security evidencing indebtedness or a stock and for that reason most of them deserve no special comment. The securities contained no terms or conditions inconsistent with a debt except the names used.

It should be noted, however, that the holders of the securities in question were entitled to receive only the specified return on the par value of the securities and had no right under any circumstances to participate in additional profits of the company. Also they had no right to vote or otherwise participate in the management of the company as long as the securities were not in default. If there was a default in payments which continued for ninety days, thereafter and until the default was cured the holders of the securities in question had exclusive voting rights. When the default was cured the voting rights reverted in the common stock. Under the law of Delaware voting rights could be granted to bondholders.

*Delaware General Corporation Law, Sec. 29.*

Petitioner was required to use the proceeds received from the sale of its cumulative preferred serial stock for the acquisition of property suitable for the purposes of the corporation. It was further provided that the par value of petitioner's outstanding cumulative preferred serial stock, together with the total bonded indebtedness, should not exceed 100% of the appraised value of the property of the corporation. If petitioner sold any of its properties it was required to apply the proceeds in the

acquisition of other property of substantially equal value or to the retirement of its cumulative preferred serial stock or bonded indebtedness. [R. 148-150.]

At the time petitioner's securities designated cumulative preferred serial stock were sold there was in effect a lease agreement whereby petitioner leased properties to Pacific Southwest Trust and Savings Bank and in which said bank agreed to pay an annual rental which, together with other income of petitioner, would be sufficient "to pay all operating costs of Lessor (petitioner), maintenance, upkeep, repairs, taxes (including special assessments), and insurance on the properties owned by it, *and in addition all interest, dividend, and amortization charges on its outstanding bonds and preferred stock issued or to be issued by it.*" (Italics supplied.) [R. 176.] By said lease agreement the bank in effect guaranteed the payment of the so-called dividends on petitioner's cumulative preferred serial stock and guaranteed the retirement thereof on the maturity dates specified. The above provision in the lease was called to the attention of the prospective purchasers of said securities and it was pointed out that the payment of the so-called dividends and the retirement of the securities was assured by the rental contract. [R. 160, 169.]

### 3. *Intent of the Parties.*

The established rule of law is that the intent of the parties to a contract is to be determined from the terms of the contract.

*California Civil Code*, Sec. 1639.

It is clear from the terms and conditions of the securities in question and from the statements issued in regard

thereto that the intention of petitioner in issuing these securities was to secure the use of money for a definitely determined period for a definitely determined charge. Petitioner clearly bound itself to repay the principal sums on the dates specified and bound itself to pay  $6\frac{1}{2}\%$  and  $5\frac{1}{2}\%$  per annum of the par value of the securities on or before the specified maturity dates. Petitioner's obligation was not dependent upon earnings or profits but was enforceable against the general assets of petitioner, the same as any unconditional claim or debt against the corporation. The obligation which was created and which the parties clearly intended to create was an obligation which the law calls a debt.

Notwithstanding the express and intentional provisions of the securities petitioner named the securities preferred stocks and named the payments thereon dividends. There is nothing in the record, however, which in any way indicates that in using said names the parties intended to limit or alter the obligations expressly imposed upon petitioner under the express terms of the security. Likewise, the use of said names in no way affected petitioner's express obligations. It has been the use of these names which has caused the confusion and controversy in this case. If petitioner had named the securities debentures and had named the payments thereon interest, there could be no doubt that petitioner was indebted to the holders of the security and that the payments thereon were actually interest.

The parties may have thought that the securities which they had created were a special type of stock with unusual provisions. The use of the word "serial" in the name, however, indicates that the securities were not considered to be ordinary preferred stock. It is also clear



from the statements made in the prospectus that it was clearly understood that the investment was for a limited time and that on or before the maturity date specified the principal sum was to be repaid, with accumulated fixed dividends, from the general assets of petitioner if necessary. There is nothing to indicate that particular significance attached to the names used. The terms of the securities were so clearly and definitely stated that the rights between the parties could not have been affected by whatever name was used. If, by reason of the express terms of the contract, it should be classified as a debt, the fact that the parties called it a stock is of no importance. Other parties have named their securities debts and named the payments thereon interest but the courts have nevertheless looked to the terms of the securities and determined that they were stocks and the payments were dividends.

*Commissioner v. Schmoll Fils Association, Inc.*  
(C. C. A. 2, 1940), 110 Fed. (2d) 611;

*United States v. South Georgia Railway Co.* (C.  
C. A. 5, 1939), 107 Fed. (2d) 3;

*Ticker Publishing Co. v. Commissioner*, 46 B. T.  
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Petitioner submits that the names given to the securities and the payments thereon did not change the obligations of petitioner and that the true character of a security should be determined from the terms of the contract and not by the names used by the parties. The terms of the securities in question classify them as debts and not as stocks.

D. ANALYSIS OF DECISION BELOW.

The basis of the conclusion of the Board of Tax Appeals that petitioner was not indebted to the holders of its securities called cumulative preferred serial stock is not entirely clear but from the statements in the opinion it appears that the Board's decision was based primarily upon the following facts and conclusions:

1. There is no evidence that the holders of the securities were unwilling to become stockholders.

2. The Board's conclusion that if the securities represented indebtedness petitioner violated its Certificate of Incorporation.

3. The securities were referred to as preferred stock and the payments thereon were referred to as dividends.

There is no evidence herein that the holders of petitioner's securities would not have purchased preferred stock but such condition has never been considered a prerequisite to indebtedness. Such evidence has been considered in some cases in determining that a security which did not appear from its terms to be indebtedness was actually indebtedness because the parties so intended.

*Commissioner v. Proctor Shop, Inc.* (C. C. A. 9, 1936), 82 Fed. (2d) 792;

*Commissioner v. Palmer, Stacy-Merrill, Inc.* (C. C. A. 9, 1940), 111 Fed. (2d) 809;

*Arthur R. Jones Syndicate v. Commissioner* (C. C. A. 7, 1927), 23 Fed. (2d) 833.

Petitioner has never contended that there was any agreement or understanding between it and the holders of its securities other than the terms of the securities

themselves. It is submitted that where the security by its own terms and conditions is an indebtedness, whether or not the parties would have been willing to purchase some other type of security is entirely immaterial.

The Board places considerable emphasis upon its conclusion that if petitioner's securities are held to be indebtedness petitioner violated its Certificate of Incorporation. [R. 54, 59.] The Board bases its conclusion upon the provision in petitioner's Certificate that "The aggregate indebtedness of the corporation secured by mortgage, deed of trust or otherwise shall not exceed Fifty percent (50%) of the appraised value of the property subject thereto." [R. 148.] It is apparent from the above quotation that the restriction applied only to secured indebtedness. It has never been contended and there is nothing in the facts herein to indicate that the indebtedness of petitioner to the holders of its securities designated cumulative preferred serial stock was in any way secured. It is submitted that the conclusion of the Board is erroneous and in direct conflict with the facts in this case.

It is true that the securities in question were named preferred stock and the payments to be made to the holders thereof were named dividends. In its dealings with prospective purchasers and holders of said securities petitioner consistently referred to the securities as preferred stock. The payments on said securities were referred to as dividends and were handled by petitioner as dividends. Petitioner's manner of reference to the securities was merely consistent with the name which had been given to the security. As stated above in this brief, the names used did not and were not intended to change the terms of the contract and the true character of a security is to



be determined from the terms and conditions thereof and not from the names used. From the opinion below it appears that the decision of the Board was based almost entirely upon the fact that the securities were called preferred stocks, the payments were called dividends, and the other acts of petitioner which resulted from the use of said names.

The Board in its opinion gave no real consideration to the fact which this Court and the other courts and the Board in other cases have held to be the determining factor in similar cases, namely, the fact that petitioner had an enforceable obligation to redeem the securities and pay the accumulated so-called dividends on or before definitely specified dates and that the obligation was enforceable against the general assets of petitioner, the same as **any** unconditional claim or debt against the corporation. The Board disposed of this fact with the following comment:

“These provisions, petitioner contends, make the securities an ‘indebtedness.’ Respondent denies that they have any such effect, points out that the right to enforce the payment as an unconditional claim or debt appears to be limited to the holders of any series then in default, which, so far as this record shows, never occurred, and argues that ‘the interest of any person in the assets of a corporation must necessarily be either as a creditor or as a proprietor’, but can not be both at the same time.” [R. 57.]

If petitioner correctly understands the above quoted statement, it means that no obligation to pay on a future date is a debt until the payment date arrives and the payor defaults. If that statement is correct there are no debts except those in default for no creditor can enforce payment of a debt prior to the due date and if a debt is paid

on the due date there is no default. The same statement could be made about any bond or debt. It is respectfully submitted that the above statement is clearly erroneous. The fact that petitioner never defaulted, but paid its obligations in accordance with the terms of its securities, certainly does not justify a conclusion that the security was not a debt.

Petitioner agrees that a person cannot be both a stockholder and a creditor by reason of a single interest in a corporation but petitioner's contention is that the holders of its securities were not stockholders but were in fact creditors.

The Board also suggests that the redemption of petitioner's securities might not have been enforceable to the detriment of general creditors or bondholders. This Court has held that an obligation may be a debt even though it is specifically made subordinate to the claims of general creditors.

*Commissioner v. Proctor Shop, Inc.* (C. C. A. 9, 1936), 82 Fed. (2d) 792;

*Commissioner v. O. P. P. Holding Co.* (C. C. A. 2, 1935), 76 Fed. (2d) 11.

The Board cited *Brown-Rogers-Dixon Co. v. Commissioner* (C. C. A. 4, 1941), 122 Fed. (2d) 347, in support of its final conclusion. In that case the securities being considered had no maturity date and the Court stated:

"There was no due or maturity date fixed for the payment of the principal. It has been repeatedly held that one of the fundamental characteristics of a debt is a definite determinable date on which the principal falls due."

It is respectfully submitted that petitioner's securities designated 6½% Cumulative Preferred Serial Stock and 5½% Cumulative Preferred Serial Stock represented indebtedness of petitioner to the holders thereof and that the so-called dividends paid by petitioner to the holders of said securities were in fact interest on indebtedness within the meaning of Section 23(b) of the Revenue Act of 1936 and were deductible for income tax purposes. Petitioner further submits that the Board of Tax Appeals erred in holding that said securities were not debts and that the payments thereon were not interest.

## ISSUE II.

### Discount Expense.

It is stipulated herein that petitioner's securities designated 5½% Cumulative Preferred Serial Stock were issued and sold at a discount and that if said discount is deductible \$1,833.26 was allocable to 1936 and \$31,275.39 was allocable to 1937. [R. 141.] Respondent refused to allow the deduction of the discount expense on the ground that petitioner's securities were preferred stocks. Since it is well established that the discount at which bonds and other securities evidencing indebtedness are sold is deductible (*Regulations* 94, Art. 22(a) 18) the determination of whether petitioner is entitled to deductions for said discount expense depends upon the determination of whether petitioner's obligation to the holders of its said securities was a debt. Reference is made to the facts and arguments stated under Issue I. The decision of the Board of Tax Appeals that the discount expense was not deductible was based upon its conclusion that the securities were not debts. [R. 51.]

### ISSUE III.

#### Premiums Paid.

It is stipulated that petitioner redeemed its securities designated 6½% Cumulative Preferred Serial Stock during the year 1936 for the face value of the securities plus a premium of \$182,025.00 and redeemed its 5½% Cumulative Preferred Serial Stock during the year 1937 for face value of the securities plus a premium of \$20,000.00. [R. 142.] Respondent refused to allow the deduction of said premiums on the ground that petitioner's securities were preferred stocks. Since it is well established that if a corporation purchases its bonds or other securities evidencing indebtedness at a premium the excess of the purchase price over the issuing price is a deductible expense (*Regulations 94*, Art. 22(a) 18) the determination of whether petitioner is entitled to deductions for the premiums paid depends upon the determination of whether the petitioner's securities represented indebtedness. Reference is made to the facts and arguments stated under Issue I. The decision of the Board of Tax Appeals that the premiums paid were not deductible was based upon its conclusion that the securities were not debts. [R. 51.]

#### CONCLUSION.

1. Since under the specific terms of its securities designated 6½% Cumulative Preferred Serial Stock and 5½% Cumulative Preferred Serial Stock petitioner was required to repay the par value of said securities plus all accumulated so-called dividends on or before the maturity dates specified and said obligation was enforceable against the general assets of petitioner, the same as any claim or debt against the corporation, said securities were not

stocks but in fact represented indebtedness of petitioner to the holders of the securities and:

- a—The so-called dividends paid to the holders of said securities were in fact interest payments on indebtedness and were deductible under Section 23(b) of the Revenue Act of 1936.
- b—The discount at which the 5½% Cumulative Preferred Serial Stock was issued was a deductible expense and the portions thereof properly allocable to the years 1936 and 1937 were deductible in those years.
- c—The premiums paid by petitioner upon the redemption of said securities were deductible expenses for the years in which paid.

2. The Board of Tax Appeals erred in refusing to allow the deduction of said interest paid, discount expense and premiums paid.

3. The decision of the Board of Tax Appeals should be reversed.

Respectfully submitted,

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*Of Counsel:*

L. A. LUCE,

March, 1942.

